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EU Financial Reforms – Impact on Commodities Markets

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Introduction

The year 2010 will be remembered as one in which dramatic reform was imposed on the global over-the-counter (OTC) derivatives markets. Landmark legislation has been enacted in the United States in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Proposals for change are pending in several countries operating in the Asian markets, including Japan and Hong Kong. Most recently, in September 2010, the European Commission (EC) published its formal proposals designed to regulate the OTC derivatives markets through enhanced market oversight, reduced operational and counterparty risk in trading, and increased market transparency (the EC Proposals).[1] The EC Proposals build upon and strengthen previous communications from the EC, issued between July and October 2009, which examined the role that derivatives played in the financial crisis, the inherent benefits and risks of the derivatives markets, and how risk can be reduced.

The key measures through which the EC intends to achieve its goals include the establishment of trade repositories, the increased use of central counterparty clearing, and further standardisation of OTC contracts (which hitherto have been exempt from formal regulation). If enacted in their current form, the EC Proposals, which are slated for implementation by December 2012, seem likely to result in substantial changes to the structure and regulation of the EU commodities market. These potential changes are magnified when viewed in conjunction with the review of other pieces of ongoing EU legislation, most notably the Markets in Financial Instruments Directive (MiFID) and the Market Abuse Directive (MAD).

Executive Summary

The importance of the EC Proposals on OTC derivatives cannot be underestimated. The EC, in conjunction with the G-20, is seeking to tame a market that it believes has been fuelled by excessive speculation. If enacted as currently drafted, trading companies operating on a cross-border basis will have to consider changes to long-standing business practices.

This *White Paper* examines the main provisions put forward by the EC and how the EC Proposals will affect trading entities both in Europe and the United States. It also will consider the key differences and the points of overlap between the EC Proposals and the Dodd-Frank Act in the United States. Finally, it will address potential additional reforms that may be implemented with respect to physical commodities markets.

G-20 Pittsburgh Summit

In September 2009, at the G-20 Pittsburgh Summit, the leaders of the world's 19 biggest economies, along with the EU (categorised as the G-20's 20th member[2]), agreed that "all standard OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest". This progressed the ideas that were originally put forward at the G-20 summit in London in May 2009. At the European Council meeting in June 2010, EU Member States undertook to conclude all of the negotiations relating to the G-20 commitments on financial reform by the end of 2011. Furthermore, the G-20 leaders acknowledged that "OTC derivative contracts should be reported to trade repositories and that non-centrally cleared contracts should be subject to higher capital requirements". The EC Proposals meet the G-20 commitments, as set out in the 2009 Summit, on OTC derivatives markets.

Given that OTC derivatives account for almost 90 per cent of the derivatives markets,[3] it was essential to regulators that a strong legislative and regulatory framework be put into place. The EC Proposals cover all areas of the OTC derivatives market, including interest rates, credit, equity, foreign exchange and commodities.

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[1] All terms not defined herein are to be construed as defined in the EC Proposals.
[2] Four EU Member States are represented directly: France, Germany, the UK and Italy.
[3] Europa.eu: "Commission proposal on OTC Derivatives and Market infrastructures – Frequently Asked Questions", September 2010.

Michel Barnier, the European Commissioner leading the EC Proposals, has underlined the EC's view that OTC derivatives have had a wide-reaching impact on the economy, affecting everything from mortgages to food and energy prices. The aim of the increased regulation is to remove the fundamental uncertainty which allegedly underpins the OTC derivatives markets.

The EC Proposals were later supplemented with pronouncements from Commissioner Barnier at the opening speech of the conference on the revision of the MiFID.[4] Commissioner Barnier explained that revisions were necessary to address the significant changes that have occurred in the financial world since MiFID was originally drafted and transposed into local law throughout the EU in 2007 and 2008. The commodities angle was brought into focus when Commissioner Barnier stated that changes are required to reinforce regulatory control over the currently volatile commodity market, and that MiFID is "one of the key elements of an ambitious reform of the raw materials markets".

A. The EC Proposals

The EC has taken a three-pronged approach to reforming the OTC derivatives markets: (1) increasing transparency; (2) reducing counterparty risks; and (3) reducing operational risks.

1. INCREASING TRANSPARENCY

Under the current system, neither policy regulators nor market participants are clearly or expeditiously able to get a comprehensive 'snapshot' of the position of the OTC derivatives markets at any given time. The EC Proposals aim to increase transparency by mandating the reporting of OTC derivative trades to various central data centres, known as trade repositories.[5] Under the EC Proposals, access to trade repositories would be granted to EU and non-EU financial services regulators, in order to allow for a better monitoring of the market and the ability to detect any concerns or risks before they materialise or escalate. The newly created European Securities and Markets Authority (ESMA) is tasked with supervising the trade repositories. Trade repositories will be required to publish positions, by classes of derivatives, thereby granting a clearer and more transparent view of the OTC derivatives markets.

Under the EC Proposals, there are currently two alternatives as to who will regulate and supervise the trade repositories. One option is that the trade repository registers with its national competent authority, which would be responsible for ensuring the trade repository's proper functioning. The second alternative is that trade repositories would be registered with, and run by, ESMA. The latter is seen as the more favourable option by the EC from a cost / benefit perspective. The former option is seen as being somewhat inefficient and cumbersome, due to the requirement that will be placed on the national competent authority to pass information to ESMA. Therefore, rather than a national competent authority adding an intermediate layer of bureaucracy, the EC Proposals suggest that registration with, and running of, trade repositories will be most efficiently done by ESMA.

2. REDUCING COUNTERPARTY RISK

It is felt that the credit risk of counterparties currently is not sufficiently mitigated with participants in the OTC derivatives markets due to inadequate or non-existent collateralisation of trading positions. The provision of security by counterparties by way of cash or guarantee, prior to entering into a transaction, is not as commonplace as the EC would like to see. Consequently, a risk arises every time one party to an OTC transaction is unable to make the required payment as and when it is due. The EC hopes to neutralise this concern by requiring the clearing of standardised OTC derivatives through central clearing counterparties (CCPs).[6] Clearing an OTC derivative contract through a CCP usually will involve the posting of higher amounts of collateral than if a contract is not cleared through a CCP. Therefore, increased collateral would be held by the CCP, automatically safeguarding each party against the failure of the other.

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[4] Brussels, Monday, 20 September 2010.

[5] A trade repository is a body that centrally collects and maintains records of OTC derivatives. The EC Proposals state that "in order to obtain registration, a trade repository will have to comply with strict requirements ensuring the confidentiality, integrity and protection of the information it receives and maintains".

[6] The UK currently has three EC recognised CCPs: LCH. Clearnet Ltd; Euro CCP; and ICE Clear Europe.

CCPs would have the role of acting as an intermediary between the buyer and seller, and would be a safety net preventing the automatic collapse of one market participant following the prior collapse of another market participant. The CCP would be able to choose which contracts to clear, and authority to carry out that clearing would be granted by a national authority.

The increased amount of collateral that will be held by CCPs means that the CCPs themselves will be subjected to increased risk. To mitigate the risk that CCPs will in turn pose to financial systems, the EC Proposals, along with other pieces of legislation, including MiFID, the Market Abuse Directive,[7] Transparency Directive[8] and the Capital Requirements Directive,[9] will impose stringent conduct of business rules, internal governance, audit checks and requirements, and organisational and prudential requirements. This will ensure that the risks that could be posed by CCPs are managed properly and that they are therefore safe to use. CCPs will also be required to demonstrate that they have access to adequate levels of liquidity. The liquidity will be available to CCPs from central banks and creditworthy commercial banks.

3. REDUCING OPERATIONAL RISK

Finally, the EC hopes to encourage the use of electronic facilities to confirm the terms of an OTC derivative contract, as opposed to the current system of complex, bespoke contracts, which increase the risk of human error. It is thought that reducing the requirement for manual intervention in the various stages of the buying and selling process will decrease the operational risk that surrounds the trading of derivatives on OTC markets.

It has also been suggested that electronic reconciliation and confirmation of the contract is a potentially valuable tool to ensure that details of trades are agreed early and accurately, and can be used in both high- and low-velocity markets.

B. Who do the EC Proposals apply to?

The EC Proposals are aimed primarily at OTC market traders, banks (both universal banks and investment banks), insurance companies and funds. They also will apply to energy companies, airlines and manufacturers that have large positions in OTC derivatives. While the aim is to standardise the market as a whole and present an approach coordinated at a European-wide level, the EC has chosen to exempt users from the new requirements. Non-financial firms using OTC derivatives to mitigate risk arising out of their principal business activities would be exempt from the CCP clearing and reporting requirements. Thus, for example, the exemption from the obligation to clear an OTC derivatives contract through a CCP or report the transaction to a trade repository will apply to companies such as airlines and utilities, unless their OTC derivatives positions reach a threshold at which they are considered to be systemically important.

The EC gives the examples of commercial hedging carried out by non-financial entities such as airlines using OTC derivatives to secure the price at which they buy fuel, or when exporters use OTC derivatives to shield themselves from fluctuations of exchange rates. The aforementioned clearing and reporting exemptions will only apply to the non-financial companies up to the point where their positions "reach a threshold and are considered to be systemically important". ESMA, together with the new European Systemic Risk Board and other relevant authorities, will draft technical standards on what these thresholds should be. No date has, as yet, been set for when these will be published.

C. Comparison with the US Legislation[10]

Market commentators have said that the EC Proposals will result in increased convergence of EU financial regulation with that of the United States, despite the fact that some initially had believed that the EC Proposals

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[7] 2003/6/EC.
[8] 2004/109/EC.
[9] 2006/48/EC; 2006/49/EC.
[10] For a comparative summary of the US legislation and the EC Proposals, see Annex 1.

might differ greatly from the Dodd-Frank Act. This convergence on key issues should reduce opportunities for regulatory arbitrage. There will therefore be fewer opportunities for market players outside of Europe and the United States to exploit the differences between the two systems of regulation and attract OTC derivative business to their markets.

The Dodd-Frank Act, which was signed into law by US President Barack Obama on 21 July 2010, has the stated aim of “promoting the financial stability of the United States by improving accountability and transparency in the financial system”. The scope of both the Dodd-Frank Act and the EC Proposals are, on the whole, very similar. Both apply to a broad class of OTC derivatives, and exclude spots and forward contracts. Both legislative proposals also allow for the recognition of non-domestic CCPs, thereby permitting cross-border clearing in certain circumstances.

In a clear sign that transatlantic cooperation is seen as being essential to the success of the EC Proposals and the Dodd-Frank Act, Commissioner Barnier and the US Commodity Futures Trading Commission (CFTC) Chairman Gary Gensler re-affirmed their close working relationship at the end of September 2010. In a joint statement, both confirmed their determination to cooperate closely in strengthening the global financial system. Chairman Gensler and Commissioner Barnier discussed the regulatory reform of the OTC derivatives markets with respect to the Dodd-Frank Act and the EC Proposals.

Commissioner Barnier said, “We have proven on OTC derivatives regulation that close transatlantic cooperation can work. It’s essential – across the board on all financial regulation – that the United States and Europe move in parallel and that we don’t create new space for regulatory arbitrage.”

The close working relationship between the EC and the United States was cemented further when the CFTC's Global Markets Advisory Committee hosted senior personnel from the EC and the Japanese Financial Services Authority on 5 October 2010. The participants at the conference discussed their respective approaches to OTC derivatives reform.

1. CLEARING OBLIGATIONS

The EC Proposals include a clearing exemption for non-financial counterparties that is similar to the end-user exemption from clearing in the Dodd Frank Act. Under the Dodd-Frank Act, a non-financial entity may opt out of the clearing obligation if it is using the swap to hedge or mitigate commercial risk and notifies the CFTC of how it meets its financial obligations associated with entering into non-cleared swaps.

This ‘end-user’ exemption is similar to the exemption under the EC Proposals for non-financial entities, although under the EC Proposal, such entities also must be deemed to not be systemically important. Some commentators believe that this provision in the EC Proposal could be abused depending on what threshold the EC sets for a position to be considered systematically important. The rationale behind the clearing exemption for non-financial entities appears to be the same in all jurisdictions: non-financial counterparties are not seen as posing the same level of risk to the markets, therefore a distinction has been made in the legislation between them and financial counterparties.

2. MANDATORY CLEARING OBLIGATIONS

The EC Proposals require mandatory clearing of many OTC derivative contracts. The EC Proposals set out two tranches to determine which contracts must be cleared: (a) a 'bottom-up' approach, in which the relevant competent authority in the Member State in question would authorise the CCP to clear a class of derivatives, following which the competent authority would then be obliged to inform ESMA of who will have the powers to decide whether a clearing obligation should apply to that class of derivatives in the EU; and (b) a 'top-down' approach, in which ESMA, on its own initiative and in consultation with the European Systemic Risk Board, would identify contracts that should be subject to the clearing obligation, but for which no CCP has yet received authorisation. The ‘bottom-up’ and ‘top-down’ approaches would work in parallel with one another, rather than being mutually exclusive. A swap would therefore have to be cleared if it meets either test.

This two-pronged requirement ensures that no OTC derivative contract that should be cleared slips through the net. For example, if the competent authority in a particular Member State does not authorise a CCP to clear a class of derivatives, ESMA would have the power to overturn the decision made by the competent authority and require that a particular contract be cleared, even if the CCP has not received the approval for clearing from its competent authority. This approach also ensures that the clearing requirement applies to new products, for which formal legislative proposals have not yet been considered.

The EC Proposals set out specific criteria for ESMA to determine whether a contract should be cleared, including the following: (a) whether or not the clearing would result in the reduction of systemic risk in the financial system; (b) the liquidity of the contracts proposed for clearing; (c) what information regarding pricing is available at the time the decision is made by ESMA; (d) the volume of contracts being proposed for clearing and whether the CCP is able to handle that volume of contracts; and (e) the level of client protection provided by the CCP.

The subjectivity of some of these criteria, namely whether the clearing of the contract reduces systemic risk in the financial system, suggests that there is a certain element of fluidity and flexibility afforded to ESMA when deciding whether to clear an OTC derivative contract.

The EC explained its rationale for not imposing mandatory clearing for all OTC derivatives by referring to the customised nature of certain derivative contracts to meet particular counterparty or end-user needs. Highly bespoke OTC derivatives will not, therefore, meet the standards required for central clearing as they will not pose a high enough level of risk. In one sense, the EC Proposals appear slightly stricter in that they require clearing if the (currently unascertained) threshold is exceeded. On the whole, though, the EC Proposals are viewed as being slightly less onerous on end-users than the US legislation.

3. REPORTING OBLIGATIONS

Under the EC Proposals, non-financial counterparties will, in general, not be subject to the reporting obligation set out under the EC Proposals, unless their OTC derivatives positions reach a threshold at which they are considered to be systemically important. This exemption could potentially be viewed as a way of justifying the concerns of certain traders and hedge funds who believe that the EC Proposals will not give a fair and accurate portrayal of the OTC market as a whole, which was the EC's stated aim at the outset of the consultative process. This could be exacerbated further by the obligation of mandatory reporting requirements on financial institutions, thereby giving market participants a distorted view of the status of the market. There is no equivalent 'end-user' reporting exemption for non-financial counterparties under the US legislation. Under the Dodd-Frank Act, all uncleared swaps must be reported to a registered trade repository.

On 1 October 2010, the CFTC held a public meeting to discuss 'pre-enactment' swaps. Pre-enactment swaps are those outstanding on 21 July 2010. An interim rule regarding the reporting obligations for such pre-enactment swaps was unanimously approved. Although the reporting of pre-enactment swaps is required by the Dodd-Frank Act, the interim rule does not, yet, require any specific reporting. The aim of the interim rule is to provide for retention of certain swap data until the CFTC establishes permanent reporting rules. Although the interim rule is effective from 1 October 2010, the CFTC will continue to accept comments for a 30-day period from that date before the interim rule takes its final form. The final rule will then be proposed later this year.

The interim rule provides details as to the reporting requirements for pre-enactment swaps; these requirements are expected to be introduced with the publication of a final rule. Specifically, the interim rule details the type of information regarding pre-enactment swaps that swap participants should retain in the event they are captured by the final rule on reporting. The interim rule also identifies the counterparties responsible for reporting. As the definition of 'swap' remains undetermined under the Dodd-Frank Act, the full scope of the reporting requirements for pre-enactment swaps remains unknown.

4. BUSINESS CONDUCT STANDARDS

One of the main distinctions between the Dodd-Frank Act and the EC Proposals is that certain issues concerning the trading and transparency of OTC derivatives will not be addressed by the EC Proposals, as they will be dealt with separately under a review of MiFID, which is currently being undertaken by the EC. Furthermore, whereas the Dodd-Frank Act requires the registration of swap dealers and major swap participants, this, along with other conduct of business rules, is dealt with in the EU by MiFID, and the EC Proposals do not extend the registration requirements. In the US, the CFTC will establish new conduct of business rules, along with those prescribed by the Dodd-Frank Act. Certain aspects of the Dodd-Frank Act are also covered in the Market Abuse Directive,[11] which prohibits short-selling when used to manipulate the market when combined with insider information, and the Transparency Directive,[12] which requires the disclosure of significant long positions. Certain amendments will also be made to the Capital Requirements Directive,[13] which will deal with the differentiation of capital charges between CCP cleared and non-CCP cleared contracts. However, not all aspects covered by the European directives mentioned hitherto, are covered by the Dodd-Frank Act.

Both the EC Proposals and the Dodd-Frank Act impose restrictions and obligations on financial counterparties. The details of these restrictions and obligations differ between the two pieces of legislation. Under the EC Proposals, financial counterparties must have in place certain arrangements which would allow for the mitigation of any operational and associated credit risk. As discussed earlier, this would be achieved via a system of electronic confirmation of contracts, to avoid human error that arises upon the use of bespoke contracts.

Other arrangements include swap dealers and major swap participants having capital and margin requirements with regard to uncleared trades; it is not yet certain whether these will apply to uncleared trades with end-users. Swap dealers and major swap participants will also be required to verify their contract participants and eligible contract participants, but there is no further suitability determination required at this point. The remaining arrangements for mitigating risk deal with the reconciliation and exchange of collateral and an adequate holding of capital (the level of which is yet to be ascertained). The initial margin will have to be segregated by swap dealers and major swap participants if requested by the end-user. The requirements set by the Dodd-Frank Act focus more on the swap dealers and major swap participants themselves, including the imposition of capital and margin requirements. This would apply to those who enter into uncleared swaps. The level of capital and margin requirement would be appropriate for the heightened risks posed by uncleared swaps.

5. REGULATION OF CCPS AND DCOS

Under the EC Proposals, there are provisions regarding the regulation of CCPs, including conduct of business and organisational structure. Some particular requirements include ensuring that the CCP has access to liquidity (through the central bank and / or a creditworthy and reliable commercial bank) and the specification of margins covering 99 per cent of risk exposure movements over a certain period of time.

In the US, under the Dodd-Frank Act, regulators have been tasked with setting the standards for the organisational and business conduct of Designated Clearing Organisations (DCOs), the US equivalent to European CCPs. There are requirements regarding collateral for cleared swaps to be held with a futures commission merchant or a broker, dealer or securities swap dealer. In addition, there is a specific stipulation that a registered DCO is not required to accept the credit risk of another DCO.

A distinction in the US legislation regarding CCPs relates to their ownership. Under the Dodd-Frank Act, regulators will have the power to determine whether or not large banks and financial holding companies supervised by Federal Reserve should be prevented from owning DCOs. There is no corresponding provision in the EC Proposals specifically relating to large banks and financial holding companies. However, CCPs in the EU must disclose, and monitor vigorously, the identity of their shareholders. The regulator is entitled to refuse the authorisation of a CCP if it is not satisfied with the suitability of the CCP's shareholders. The CCP must also disclose any close links that it has with any natural or legal persons. If the regulator considers the persons to be heavily influential in the management of the CCP, the regulator will take "appropriate measures to terminate the situation". Such measures include the removal of a board member.

The US legislation indicates a clear 'separation of powers', as it were. The CFTC appears to be taking the position that a large bank or financial holding company should not have the power to both own a DCO and carry out extensive trades through it.

[11] *Ibid.*
[12] *Ibid.*
[13] *Ibid.*

6. NON-CROSS-BORDER PROVISIONS

Two much-discussed provisions of the Dodd-Frank Act have been the 'Volcker Rule' and the 'push out' provision.

The Volcker Rule prohibits any 'banking entity' (*e.g.*, an insured bank, a company that controls an insured bank, a bank holding company, or any affiliate of such an entity) from engaging in proprietary trading. The Volcker Rule applies to foreign banks with US affiliates, as well as those banks operating in the United States.

There are various exceptions for 'permitted activities', including certain risk-mitigating hedging activities, certain proprietary trading that occurs solely outside of the United States (provided that the banking entity is not controlled by a banking entity organised under US law and if the trade is taking place with a non-US counterparty), and "such other activity as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the CFTC determine, by rule would promote and protect the safety and soundness of the banking entity and the financial stability of the United States". *De minimis* investments that comply with certain requirements are also permitted.

The push-out provision, which limits the ability of federally insured 'swap entities' (*e.g.*, swap dealers and major swap participants) to engage in certain swap-related activities has also been the subject of much debate. Bona fide hedging involving interest rates, currencies and certain assets (*e.g.*, gold, silver and other forms of bullion) are excluded from the prohibition. Other swap activity must be 'pushed out' to a separate swap affiliate that complies with the requirements of certain provisions of the Federal Reserve Act and other regulations that may be promulgated by the Securities and Exchange Commission (SEC), CFTC and / or Federal Reserve System.

There is no equivalent provision for either of these two rules in the EC Proposals. This means that banks within the EU are not limited as to how much OTC derivatives business they carry out. By not drafting provisions equivalent to that of the Volcker Rule and the push-out provision, the only way that the risk can be mitigated is by the posting of collateral to CCPs before the transaction is entered into. Not having an equivalent to a push-out provision means fewer restrictions being placed upon swap entities compared to such entities trading in the US markets. Of course, there is still time for amendments to be made to the EC Proposals and therefore introduce provisions that are similar to the Volcker Rule and the push-out provision.

7. TERRITORIAL SCOPE

In terms of territorial scope, the Dodd-Frank Act does not apply to any derivatives traded wholly outside the US that only involve non-US counterparties. However, US regulators have the option of making regulations and imposing them upon entities in countries whose regulations may affect the financial stability of the US and, if necessary, preventing them from participating in US derivative trading activities. Activities that are carried out outside the US may be regulated, to the extent the activities (a) have a direct and significant connection with activities in, or effect on, commerce of the United States, or (b) contravene such rules or regulations as the SEC may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of the act that was enacted by the Wall Street Transparency and Accountability Act 2010. The CFTC historically has construed 'activities' to be separate from 'transactions', so it is unclear how this provision applies to swap transactions as opposed to soliciting, entering into and advising US customers about swap transactions.

The territorial application of the EC Proposals is not as yet entirely clear, although the EC Proposals do provide for cooperation with third countries, ensuring the competent authorities exchange information. ESMA is charged with the coordination and development of the cooperation agreements between the Member States. The EC is hoping for positive interactions with Third Countries. In order to recognise a Third Country CCP, ESMA will first need the EC to evaluate and conclude that the legal and supervisory framework of that Third Country is equivalent to that of the EU, and that the CCP is authorised by, and subject to effective supervision in, that Third Country. This will ensure that European market participants do not attempt to clear contracts through CCPs outside the EU which have lower standards than those set within the EU. Once approval has been granted by the EC, ESMA will be required to establish cooperation arrangements with the Third Country competent authorities. A Third Country CCP will not be granted permission to perform activities and services in the EU if these stringent conditions are not met.

The process for recognising a Third Country trade repository outside the EU will be subject to similar conditions as for CCPs in terms of equivalent legal regime and supervision. In addition, such regulation will be subject to an international agreement being in place between the EC and the Third Country within which the particular trade repository is located. The international agreement must deal with mutual access to data and exchange of information on OTC derivatives contracts held in trade repositories.

D. The Langen Report

The EC Proposals follow the European Parliament's adoption of the Langen Report on OTC derivatives in June 2010 (see *On the Subject,* 4 June 2010[14]). Much like the EC Proposals, the Langen Report set out recommendations encouraging financial stability and market transparency. This transparency would be achieved through extensive reporting on transactions, before and after trade execution. The Langen Report also included proposals for central counterparty clearing. One of the main points made by the Langen Report was a call on the EC to secure internationally coordinated and consistent regulation of derivatives. A tightening of cooperation between the US and all other G-20 countries was also underlined as being important to the stabilisation of currently volatile derivatives markets. The EC Proposals, combined with the Langen Report, are part of a growing wave of stricter and tighter regulation, used to promote increased transparency and stability not only of the OTC derivatives markets, but of global financial markets as a whole.

E. Further Reforms

In addition to legislative reforms, there have also been other initiatives put into place to strengthen the markets globally. The Financial Stability Board, along with the EC, set up a work stream to address the possible issues that could arise upon the implementation of the G-20 commitments, should they come to fruition. Furthermore, the OTC Derivatives Regulators' Forum was created to enhance cooperation between the relevant regulators globally. Finally, in May 2010, the Committee on Payment and Settlement Systems and the International Organisation of Securities Commissions have jointly published guidance on the application of their 2004 recommendations for CCPs to OTC derivatives. They are also currently in the process of reviewing and refining these recommendations in light of the EC Proposals and the Dodd-Frank Act and are subsequently preparing recommendations for trade repositories.

F. Timetable for Implementation

The EC Proposals are intended to be implemented by the end of 2012 and would enter into force 20 days after official publication. CCPs with existing national authorisation would have two years to obtain authorisation from ESMA. It appears that some other provisions of the EC Proposals will not be effective until the adoption of the regulatory standards (*e.g.*, the publication by ESMA of information and clearing thresholds for non-financial counterparties). Other provisions have no transitional arrangements (*e.g.,* to take account of delays in registering / recognising an initial group of trade repositories). However, over the course of the next 18 months, the EC is expected to publish more concrete guidelines concerning implementation.

The Dodd-Frank Act expressly provides that, unless otherwise specified, the legislation will not take effect until 360 days after enactment or, to the extent that any provision requires a rulemaking, 60 days after the final rule is promulgated, whichever is later.

Due to the differences between the timetables for implementation of the Dodd-Frank Act and the EC Proposals, companies operating on a cross-border level will need to closely monitor the implementation of the two pieces of legislation. For periods when a particular provision of the Dodd-Frank Act is in force, but the corresponding EC Proposal is not yet in force, it would be recommended that the company in question follows the regulation as under the Dodd-Frank Act, thereby changing their trade practices before the EC Proposals come into force.

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[14] Available at http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/196c063b-63cc-443c-ba8e-dd47032740b6.cfm.

G. Physical Commodity Derivative Reforms

The EC Proposals on OTC derivatives, along with Commissioner Barnier's comments at the MiFID conference, demonstrate a stream of legislative initiatives, legal amendments and overall globalisation of market reform. Commissioner Barnier himself is a former French minister who backed a French-led initiative to control the activities of commodity derivative traders. The EC has been under increased pressure to tighten commodity regulation as the United States is preparing to put in place legislation to tame speculative activity. One of the ways the EC proposes to do this is by reviewing the Market Abuse Directive[15] and extending its scope to cover the control and supervision of raw materials markets. Moreover, prescribed position limits, designed to counter excessive movements, may be imposed on futures markets. The intention behind these proposals is clear, but Commissioner Barnier has also warned that the EC is "ready to go further" and "will not hesitate to consider further measures".[16]

1. LEGISLATIVE CHANGES

The commodities being targeted by the French proposals include metals, oil, gas, raw agricultural products and CO_2 quotas. French President Nicholas Sarkozy has said that when he takes to the helm of the G-20 group in 2011, one of his priorities will be the introduction of increased commodity regulation. Sarkozy sees the G-20 as being the ideal forum to target the commodity markets as a whole. Showing just how important he felt commodity reform was, Sarkozy said that unless commodity prices, which are currently far too volatile, are stabilised, "we will not overcome hunger in the world, poverty and misery."[17] This further highlights the point made by Commissioner Barnier, who has spoken of wide-reaching effects of financial instruments.[18]

The views of Commissioner Barnier and President Sarkozy reflect a widely held opinion that increased regulation in the commodities market has been triggered by increased food prices, rather than energy prices. The active lobbying by bankers during the 1990s and early 2000s, aimed at weakening regulations regarding food speculation, is seen by many as the direct cause of increased food prices, which have ultimately led to increased speculation of agricultural commodities. The increased speculation, it is widely felt, must now be brought under stricter control.

Sarkozy has found an ally in the form of Russian President Dimitry Medvedev, who condemned speculators for driving up food prices and making unjustified profits by trading on the commodity markets. Medvedev could join with Sarkozy in presenting a joint proposal to the G-20 to ban speculative practices. In October 2010, German Chancellor Angela Merkel also supported the French plans, deepening an alliance against financial speculators by the eurozone's top two economic powers.

"We have very volatile commodity prices and so I would fully support that we should tackle this subject", Merkel told reporters ahead of a summit, held in Brussels, of political leaders from Asia and Europe. Merkel's remarks show evidence of a strong coalition between Paris and Berlin on reforming the way the financial industry is regulated. The influential partnership of the French and German leaders will mean that action on their demands is more likely to be taken. Speaking to the European Parliament on 5 October 2010, Commissioner Barnier promised "root and branch reform" of finance.[19]

Rather than simply adopting the US model of financial commodity markets regulation, the EC wants to adopt a unique system of regulation. This will reflect the distinct natures of the US and European markets and suit the needs and historical and cultural specificities of the participants using the two different markets. Furthermore, it will also be an opportunity for the EC to improve upon anything they feel that their US counterparts have not successfully implemented in the Dodd-Frank Act. Preliminary views suggest there would be no introduction of a mandatory cap on the number of contracts that financial investors can hold in a specific commodity at any one time. This is in stark contrast to the US legislation in which Wall Street bankers and hedge funds have prescribed

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[15] *Ibid.*
[16] Opening speech at the conference on the revision of the MiFID Directive, 20 September 2010.
[17] Keynote speech, World Economic Forum, January 2010, held in Davos, Switzerland. http://www.weforum.org/pdf/Sarkozy_en.pdf.
[18] *Ibid.* [Opening speech at the conference on the revision of the MiFID Directive, 20 September 2010].
[19] European Commissioner Michel Barnier, as quoted in http://www.thedailyherald.com/business/33-business/9013-merkel-backs-french-push-to-curb-commodity-trading.html.

limits as to how many speculative commodity contracts can be held.[20] Rather, European regulators will regulate traders' positions in a more flexible way. Such a move is unlikely to meet strong resistance from exchanges or bankers in Europe, although it could result in an increased number of US bankers transacting from Europe. It has been noted that most European watchdogs do not have the power to monitor speculative positions.

2. TRANSPARENCY

Increasing transparency at a national level is seen as the first step in convincing France's European counterparts to put forward a joint proposal for reform at the G-20. Much like the EC Proposals take their lead from US legislation, the commodity derivative reforms take aspects from the US regulatory system, but do not simply ape the US model. The purported aim is the same: greater transparency. However, while one of the drivers behind reforms in the United States were the volatile energy and agricultural prices, in Europe the sharp rise in wheat prices due to the summer drought in Russia was seen as the impetus for the legislative push. As mentioned previously, the wheat price increase reflects the increased speculation in commodities. In an unpublished letter to the EC, Christine Lagarde, France's finance minister, wrote, "We consider European regulation of trading in commodity derivatives to be insufficient." She also warned of the increased dangers caused by the lack of a regulatory and supervisory regime for physical commodity markets. Minister Lagarde believes it necessary to go a step further than the EC Proposals, focusing specifically on commodity derivatives, rather than them simply being packaged together with the terms of the proposed legislation for OTC derivatives.

The reform of the physical commodities market is being closely observed by Washington market participants. The CFTC, the US governmental regulatory body that has the stated mission of "protecting market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets",[21] is concerned that financiers from the United States could go to Europe seeking a laxer regime, curtailing their trading activities on the New York and Chicago markets. Washington lawmakers have regularly referred to the 'London loophole', demonstrating the less stringent regulation of commodities in Europe.

The UK's Financial Services Authority (FSA) has already stated that it is unlikely to back an overhaul of reforms due to the widely held belief amongst the London-based financial world that increased prices in commodity derivatives have been caused primarily by basic supply and demand fundamentals, as opposed to market speculation. The UK, along with Denmark and the Netherlands, has suggested that if reforms do go through, they should be limited. "I think it very unlikely that the EU would adopt regulations that the UK strongly opposes, because the UK is the hub for wholesale markets in Europe," said Nicolas Veron, Senior Fellow and financial regulation specialist at the Brussels-based think tank, Bruegel.[22]

The FSA's view differs considerably from the view held by French Agriculture Minister Bruno Le Maire, who has stated that speculators may have inflated the future price of commodity derivatives in the EU by up to a third.[23] This divergence of Gallic and Anglo-Saxon opinion might hinder Sarkozy's attempt to leave a lasting legacy on derivative reform during his G-20 presidency.

H. Conclusion

Prior to the EC Proposals becoming law, scheduled for 2012, they will have to be approved by the European Parliament and the Council of Ministers. Certain substantive legislative hurdles remain that will need to be overcome. The lengthy period between the tabling of the EC Proposals and their possible adoption would also suggest that amendments may be incorporated into the EC Proposals, possibly stemming from the anticipated reaction to the Sarkozy proposals expected to be put forward at the forthcoming G-20 summit in November. There

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[20] The position limits in the US apply only to futures, options on futures and swaps traded on a swap execution facility or a designated contract market that have significant price discovery roles. 'Speculative position limits' do not apply to the physical commodity markets.

[21] *See* www.cftc.gov.

[22] Available at http://www.bruegel.org/scholars/scholars-detail/scholar/nicolas-veron.html. Website has not yet been updated with the article containing this quote.

[23] Interview with Reuters on 10 September 2010.

have already been two public consultations on this topic, the responses to which are included in the impact statement accompanying the EC Proposals. The EC has assessed briefly the responses that market participants have put forward within the impact statement.

Given the increased focus on commodity markets, it seems certain that some form of possibly substantive changes will be made to how the market operates. Commissioner Barnier's views on the physical commodity markets further underline the EC's change in strategy vis-à-vis commodities; however, until formal legislative proposals are put in place it is difficult to know how comprehensive a change the market will be forced to make.

It also remains to be seen whether the distinctions between the Dodd-Frank Act and the EC Proposals will prevent the efficient cross-border passage of communication or hinder the successful mitigation of risk. Despite these uncertainties, European officials are confident that the EU-wide legislation will help bring the two legislative systems closer together, thereby going some way to stabilising a hitherto unpredictable market.

ANNEX 1 – TABLE SHOWING COMPARISONS BETWEEN MAIN ASPECTS OF THE EC PROPOSALS AND THE DODD-FRANK ACT

	EC Proposals	Dodd-Frank Act
Who is Affected?	OTC derivative dealers, financial and non-financial counterparties, trade repositories, CCPs.	OTC derivative dealers, financial and non-financial counterparties, trade repositories, DCOs.
Applicability	Wide range of OTC derivatives. Spot foreign exchange transactions and commercial foreign exchange transactions excluded. Some physically settled commodity transactions excluded.	Wide range of OTC derivatives. Spot foreign exchange transactions are not covered. Treasury Secretary has the power to exempt foreign exchange swaps and forwards from the clearing obligation. Forward contracts are excluded.
Clearing Obligations	1. Mandatory Clearing by Financial Counterparties ESMA determines which OTC derivatives are subject to the clearing obligation. ESMA identifies contracts for clearing even if no CCP clears the contract. 'Bottom-up' and 'top-down' approach. 2. Clearing by Non-Financial Counterparties May be subject to mandatory clearing if positions exceed a certain threshold. Counterparty will have to justify exceeding the threshold.	1. Mandatory Clearing by Financial Counterparties Clearing will apply according to the type of contract, rather than the status of the entity. Therefore, all contracts will have to be cleared if they are accepted by DCOs, but end-users can chose to not have the transaction cleared in certain circumstances. Regulators determine which OTC derivatives are subject to the mandatory clearing obligation. The contract will need to be cleared only if there is a DCO that currently clears the contract. 2. Clearing by Non-Financial Counterparties: end-user' exemption Can opt-out of the clearing obligation if using the derivative for hedging or mitigating commercial risk and notifies the regulator as to how it general meets its obligations under non-cleared swaps.
Reporting Obligations	Non-financial counterparties will only have to report their OTC derivative contracts if certain	All uncleared swaps must be reported to a registered swap data repository or the regulator. Pre-enactment swaps

	EC Proposals	Dodd-Frank Act
	limits are exceeded. Will be required to justify exceeding the threshold. Financial counterparties will have to report their OTC derivatives contracts to registered trade repositories, or the regulator.	(i.e., those entered into prior to the enactment of the Dodd-Frank Act and existing on the date of the Dodd-Frank Act) must also be reported. The CFTC issued an interim final rule in October 2010 specifying what records must be retained. This record retention requirement takes effect immediately.
Additional Obligations	Margin requirements and capital requirements for uncleared OTC transactions must be met. Margin requirements apply to non-financial parties only in certain circumstances. Capital requirements apply to non-financial counterparties when a certain threshold is cleared. CCPs will impose margin requirements on clearing members.	Margin requirements and capital requirements to uncleared OTC transactions must be met. Capital requirements will only apply to non-bank swap dealers and major swap participants. The margin requirements apply only to swap dealers and major swap participants. The CFTC does not have the authority to impose a margin requirement on end users.
Conduct of Business	Most conduct of business rules to be dealt with under reviews of MiFID, MAD, Capital Requirements Directive and the Transparency Directive. EC Proposals do not go further than the aforementioned Directives. MiFID already requires the authorisation of EU dealers in OTC derivatives. Restrictions and obligations placed on financial counterparties. Financial counterparties must have in place certain arrangements which would allow for the mitigation of any operational and associated credit risk. Restrictions and obligations placed on financial	The CFTC will establish new business conduct rules. The Dodd-Frank Act requires swap dealers and major swap participants to register with the National Futures Association, verify that their counterparties are eligible contract participants and comply with various disclosure requirements.

	EC Proposals	Dodd-Frank Act
	counterparties via a system of electronic confirmation of contracts. Valuation of counterparty portfolio and the reconciliation and appropriately segregated exchange of collateral or an adequate holding of capital.	
Regulation of CCPs / DCOs	Provisions regarding the regulation of CCPs include conduct of business and organisational structure. Particular requirements include ensuring that the CCP has access to liquidity (through the central bank and / or a creditworthy and reliable commercial bank) and the specification of margins covering 99 per cent of risk exposure movements over a certain period of time. No restriction regarding the ownership of CCPs. Therefore, can be owned by large banks and financial holding companies. However, the shareholders in a CCP must be identified to the regulator of the CCP. The regulator is entitled to refuse authorisation of the CCP if the regulator is not satisfied with the suitability of the CCP's shareholders.	Regulators tasked with setting the standards for the organisational and business conduct of DCOs. Requirements regarding collateral for cleared swaps to be held with a futures commission merchant or a broker, dealer or securities swap dealer. Specific stipulation that a registered DCO is not required to accept the credit risk of another DCO. Regulators will determine whether certain companies, such as financial holding companies supervised by the Federal Reserve and large banks should be prevented from owning or governing DCOs. The CFTC is currently undertaking a rulemaking to that effect. It would indicate a clear 'separation of powers'. In theory, a large bank or holding company should not have the power to both own a DCO and carry out extensive trades through it.
Non-Cross Boarder Provisions	No corresponding provisions in the EC Proposals. EU banks not restricted from entering into OTC derivatives contracts. Risk is mitigated by the posting of collateral to CCPs when the trade is entered into.	The 'Volcker Rule' prohibits any "banking entity" from engaging in proprietary trading. This includes foreign banks with US affiliates. There are various exceptions for 'permitted activities', including trading that occurs solely outside of the United

	EC Proposals	Dodd-Frank Act
		States. The 'push-out' provision limits the ability of federally insured 'swap entities' (e.g., swap dealers and major swap participants) to engage in certain swap related activities. This provision becomes effective two years following that date on which the Act becomes effective.
Territorial Scope	Not yet entirely clear. Provide for cooperation with third countries, ensuring competent authorities exchange information. ESMA charged with the coordination and development of the cooperation agreements between the Member States.	The US legislation does not expressly apply to derivatives traded wholly outside the United States (and with non-US counterparties), although regulators have option of making regulations and imposing them upon entities in countries whose regulations may affect the financial stability of the United States and preventing them from participating in US derivative activities. Activities carried out outside the US are not regulated, unless the activities (a) have a direct and significant connection with activities in, or effect on, commerce of the United States or (b) contravene such rules or regulations as the SEC may prescribe or promulgate.
Timeframe for Implementation	Come into force over the course of 2012, 20 days after official publication. Precise dates for the various provisions vary.	Most provisions of the Dodd-Frank Act will not take effect until at least 360 days after enactment or, to the extent that any provision requires a rulemaking, 60 days after the final rule is promulgated, whichever is later.

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